TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1967

No. 104

ALEXANDER TCHEREPNIN, ET AL.,
PETITIONERS,

vs.

JOSEPH E. KNIGHT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 20, 1967
CERTIORARI GRANTED JUNE 5, 1967

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[fol. A]

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Nos. 15631 and 15633

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

ROBERT FRANZ, et al., Defendants,

No. 15633

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN and LOUIS KWASMAN, Defendants-Appellants,

No. 15631

JOSEPH E. KNIGHT and JUSTIN HULMAN, Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 64C-1285

Honorable William J. Campbell, Chief Judge, Judge Presiding.

Appellant's Joint Appendix—Filed July 14, 1966

[File endorsement omitted]

[fol. 3]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION
No. 64 C 1285

ALEXANDER TCHEREPNIN, et al., Plaintiffs,

vs.

ROBERT FRANZ, et al., Defendants.

COMPLAINT—Filed July 24, 1964

Plaintiffs, by their attorneys, Arnold I. Shure and Solomon Jesmer, allege as follows, except that paragraphs 16, 17, 19, 20, 21, 23, and 24 are alleged on information and belief:

[fol. 4] 1. Jurisdiction of this Court is based upon Section 27 of the Securities Exchange Act of 1934 (15 USC §78aa).

2. Defendant City Savings Association (hereafter "City Savings") is a savings and loan association incorporated and doing business under the laws of the State of Illinois. Its principal place of business is and has been at 1656 West Chicago Avenue, Chicago, Illinois, where it has done business for more than 20 years. It was the issuer and seller of the securities sold to plaintiffs, the sale and purchase of which is the subject matter of this Complaint.

3. Defendant C. Oran Mensik (hereafter "Mensik") during all times material to this cause has been, and is, a director of, president and principal executive officer of City Savings.

4. Defendant Robert M. Kramer during all times material to this cause has been, and is, a director of and a

vice-president of City Savings. He is a brother-in-law of defendant Mensik.

5. Defendant Stanley Pasko at present, and during part, and possibly all, of the times material to this cause has been, and is, a director and a vice-president of City Savings.

6. Defendant Joseph Talarico, Jr., at present and during part, and possibly all, of the times material to this cause has been, and is, a director and a vice-president of City Savings.

7. Defendant Gloria Mensik Sprincz at present and during part, and possibly all, of the times material to this cause cause (sic) has been, and is, a director and treasurer of City Savings. She is a daughter of Mensik.

8. Each of the defendants Robert Franz and Herbert J. Hoover, at present, and during part, and possibly all, [fol. 5] of the times material to this cause has been a director of City Savings.

9. Defendant Joseph E. Knight (hereafter "Knight") is director of the Department of Financial Institutions of the State of Illinois. Defendant Justin Hulman is supervisor of the Savings and Loan Division of said Department.

10. Defendants Louis Kwasman (hereafter "Kwasman"), Harry Hartman (hereafter "Hartman"), and Dennis Kirby (hereafter "Kirby") are the three persons who have been nominated as liquidators to be elected at a meeting of the shareholders of City Savings called for Tuesday, July 28, 1964, at which meeting it is proposed that a voluntary plan of liquidation of City Savings be adopted. The latter two are employees and designees of said Department of Financial Institutions and subject to its control, while Kwasman has been designated by the Board of Directors of City Savings or someone acting for its officers or directors or for some of them.

11. Plaintiffs Alexander Tcherepnin and Ming Tcher epnin, his wife, on December 12, 1963, purchased from City Savings at Chicago, Illinois, securities issued by City Savings consisting of capital shares of and a capital account interest in City Savings, for which they paid City Savings the sum of $500.00. On January 9, 1964, they purchased additional such securities issued by City Savings for which they paid it the sum of $3,500.00.

The other plaintiffs herein purchased from City Savings capital shares issued by and capital account interests in [fol. 6] City Savings on the respective dates listed below for which they paid City Savings the amounts listed below, as follows:

Charles Noll and Maybelle Noll: December 7, 1961, $5,000; December 27, 1961, $3,500; January 30, 1962, $3,500; July 20, 1962, $1,000; October 4, 1962, $5,000; December 28, 1962, $5,000; December 27, 1963, $7,500; Total purchases $30,500.

Harry Block and Jeanette A. Block: February 6, 1964, Total purchase $1,041.82.

Werner D. Block, Jeanette A. Block and Harry Block: February 22, 1962, $8,500; July 3, 1962, $7,500; Total purchases $16,000.

Adrian Da Prato and Peter Da Prato: February 8, 1963, $2,597.42; July 29, 1963, $120.80; August 29, 1963, $65.01; Total purchases $2,783.23. Withdrawals: August 29, 1963, $15; March 5, 1964, $171. Total Balance $2597.23.

Frederick D. Wahl and Anne W. Wahl: July 17, 1962, $3,500; October 7, 1963, $102.15; January 10, 1964, $265.47; June 2, 1964, $8,422.38. Total purchases $12,290.00. Withdrawals: April 13, 1963, $290; April 6, 1964, $2,000; June 5, 1964, $1,475; Total withdrawals $3,765. Total Balance $8,525.

Theodore Machatka and Marie B. Machatka: August 30, 1962, $5,000; January 6, 1964, $1,041.19; January 13, 1964, $2,000; April 2, 1964, $500; Total purchases $8,541.19.

Joseph Novak and Frances Novak: April 2, 1964, Total purchase $500.

Marybeth Simjack: May 7, 1963, Total purchase $5,000.

Walter R. Anderson: January 3, 1963, $2,000; January 9, 1963, $3,548.85; March 21, 1963, $3,500; Total purchases [fol. 7] $9,048.85. Withdrawals: February 6, 1964, $5,000; Total balance $4,048.85.

Helen K. Kellogg on January 7, 1964, $500; on February 19, 1964, $1,000; on February 25, 1964, $500; Total $2,000.

12. Said purchases were made by plaintiffs respectively pursuant to and in reliance upon printed solicitations received by them from City Savings through the United States mails.

13. Said mailed solicitations were false and misleading in violation of Section 10(b) of the Securities Exchange Act of 1934 (15 USC 78j (b)) and Rule 10b-5 of the General Rules and Regulations promulgated thereunder. Rule 10b-5 reads as follows:

"Rule 10b-5. EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

14. Section 29(b) of the Securities Exchange Act of 1934 (15 USC Section 78cc(b)) provides in part:

> [fol. 8] "(b) . . . every contract . . . heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person, who in violation of any such provision, rule, or regulation, shall have made . . . any such contract . . . "

15. By virtue of the provisions of said Section 29(b) of said Act, the sale of said securities by City Savings to plaintiffs and the purchase by plaintiffs of said securities from City Savings was and is void, and any and all acts and things done pursuant to said sale and purchase were and are unlawful, illegal, and void, and the plaintiffs are entitled to rescind any such sales and purchases and to have the purchase prices refunded to them, together with interest at the rate of 5% per annum from the date of said respective purchases, for the reasons hereinafter set forth.

16. For many years prior to 1957, as well as since, and continuing to the present time, City Savings has been dominated and controlled by Mensik who has determined the policies and activities of City Savings in all important respects. At all times since about 1943 he has been the principal executive officer of City Savings.

17. Beginning in the year 1957, Defendant Mensik became the subject of a substantial flow of adverse publicity which has continued from time to time up to the present. This publicity originally involved the Orville Hodge scandal and defendant's suspect financial involvements with Hodge. Among other things, there were questions as to whether in return for financial favors, Hodge, as Auditor of Public Accounts of the State of Illinois, unlawfully or in some other illicit manner, favored Mensik with preferred treat-

ment in granting charters for two new reserve guarantee [fol. 9] savings and loan associations issued pursuant to a then recent amendment to the Illinois Savings and Loan Act permitting for the first time the issuance of such charters. Subsequently, the publicity related to Mensik's embroilment with the then Auditor of Public Accounts of the State of Illinois, successor to Hodge, concerning the manner in which Mensik had conducted his several savings and loan associations in the City of Chicago, the publicity covering charges of self-dealing while in a fiduciary capacity, as well as alleged mismanagement. Thereafter the publicity related to an investigation by United States postal inspectors and his criminal indictment in 1959 at Baltimore, Maryland, on charges of mail fraud involving savings and loan associations, his trial under that indictment, his subsequent reindictment in 1963, and his ultimate conviction on mail fraud charges, from which he is now appealing. There was also publicity concerning his alleged involvement with the International Guaranty and Insurance Company, of Tangiers, Morocco, which it was alleged, on a limited capitalization of less than one million dollars, had insured deposits of savings and loan associations in four or five states, totalling more than sixty-five million dollars. The publicity further related to charges that the principal assets of that insurance company consisted of a group of second mortgages with a maximum value of $600,000, acquired from a building company in which Mensik was interested. It was further alleged in such publicity that the savings and loan associations dominated and controlled by Mensik, or one of such associations, had made approximately three-fourths of its loans ($6,300,000 out of $8,400,000) to three or four building or construction companies controlled by Mensik, members of [fol. 10] his family, or close business associates. Further, such publicity related to charges that Mensik, owned and operated a company which operated safety deposit vaults and another company which operated an insurance agency which made their profits primarily from the patronage

of depositor shareholders in one or more of Mensik's savings and loan associations, the insurance premiums being derived primarily from insurance on properties of borrowers from Mensik's savings and loan associations. The publicity indicated facts warranting the possible conclusion that the operation of such safe deposit vaults and such insurance agency by Mensik were wrongful deprivations of corporate opportunities by Mensik which in fact belonged to one or more of such associations. The publicity further indicated that the rent charged by one or more of said associations to said privately owned companies of Mensik was grossly inadequate and, further that employees of the safe deposit company and the insurance agency, or persons performing services for them, were wrongfully being paid for such services by one or more of said publicly held savings and loan associations. The publicity further related to a claim by the United States Government in September, 1963, against Hodge for back income taxes in the amount of $2,700,000, of which the Internal Revenue Service listed $205,000 which it said Hodge received in unreported income from Mensik in 1955. In February, 1964, there was further publicity to the effect that the United States Court of Appeals had held Mensik liable for $301,533 in back income taxes, and that the United States Tax Court had previously held that Mensik had not reported kickbacks from a building company that remodeled the savings and loan association headquarters. Further publicity in March, 1964, [fol. 11] reported that Mensik was sentenced to five years in prison and fined $3,000 by the Federal Court in Richmond, Virginia, for savings and loan mail fraud, which sentence is being appealed, as above stated.

18. Whether or not any or all of such publicity was true or false, it was apparent from early 1957 and continuously thereafter that the name of defendant Mensik was not likely to engender trust and confidence in the minds of prospective depositor-shareholders sought by City Savings, and that it was unlikely that members of the

public would entrust part or all of their life savings to a savings and loan association headed by Mensik.

19. After Mensik's name began to be widely and unfavorably publicized, starting in about 1959 or 1960 and continuing thereafter to the present time, Mensik and the then Board of Directors of City Savings and each of the directors and officers of City Savings from time to time thereafter in office, entered into and carried out a conspiracy with each other to conceal from the public and prospective depositor-shareholders that Mensik was in any way connected with City Savings as an officer or director, and from about 1959 or 1960 to the present time, contrary to the practice of City Savings theretofore, Mensik's name has been deliberately omitted from all literature issued by City Savings, including all of the flamboyant advertising regularly issued by City Savings and sent through the United States mails on a broadcast basis throughout various states of the United States in City Savings' efforts to solicit new depositor-shareholders and additional purchases of securities by existing depositor-shareholders. This deliberate concealment of Mensik's name and the fact that City Savings was at all times under the domination and control of Mensik as its President, Director, and Chief [fol. 12]. Executive Officer, constituted the concealment and omission of material facts which, if disclosed to plaintiffs and substantially all of the other new depositor-shareholders who purchased the securities of City Savings as a result of said false and misleading mail solicitations, would have caused them to refrain from purchasing any securities issued by City Savings or paying any monies to it for depositor-shareholder capital accounts.

20. The sales literature sent out by City Savings throughout various states of the United States, through the United States mails, to plaintiffs and others, offered expensive premiums, such as TV sets, typewriters, Polaroid cameras, luggage, radios, hi-fi sets, and other items, contingent upon the size of each new purchase of depositor-

shareholder accounts or additional investment in the capital of City Savings by those already investors. Although such advertising was false and misleading in that it spoke of the financial strength of City Savings and advanced reasons as to the desirability of purchasing the securities of City Savings, each of such circulars mailed after 1957 omitted to state the very material facts that City Savings contrary to the preponderant custom of both Federal and State chartered savings and loan associations to have insurance, had been unable to arrange for insurance of depositor-shareholder accounts with the Federal Agency providing such insurance to other associations, had in fact been rejected by the Federal Home Loan Bank Board when it did apply for such insurance because of City Savings' unsafe financial policies and unsafe management, had taken out a one-year policy with the Internationl Guaranty and Insurance Company, of Tangiers, Morocco, and that such latter insurance had not been renewed by it, that said insurance company was so improperly financed and managed [fol. 13] that it had been subsequently liquidated by the State of California (where its principal office was located) and that, as a result, any investor-depositor who drew his money out of a Federally insured bank or savings and loan association to purchase depositor shares of City Savings would be uninsured thereafter as would be the situation of any other purchaser of such securities. In addition, such material facts were not disclosed to the purchasers of such securities of City Savings, including plaintiffs, at any time prior to the time City Savings closed its doors on or about June 30, 1964, on approximately which date, plaintiffs allege on information and belief, the Director of Financial Institutions of the State of Illinois took custody of its assets. Only after said closing did plaintiffs learn that Mensik was and is an officer director and in control of City Savings.

21. At all times since about 1957, City Savings has had outstanding commitments involving cash disbursements in connection with construction commitments, loans and other matters, which far exceeded its cash resources on hand. As

a result, by action of its Board of Directors, City Savings had in effect limitations as to the amount of money which many of its investors could withdraw in cash from their withdrawable capital depositor share accounts in any one year. At the present time, there are still about twelve million dollars of such withdrawable capital accounts on a "rotation" basis, meaning, on a limited annual withdrawal basis. which represent shareholder-depositor accounts in existence in 1957. In 1959, the legislature of the State of Illinois passed a law which appears as subparagraph (h) of Section 4-13 of the Illinois Savings & Loan Act (Smith-Hurd Ill. Rev. Stats. Ch. 32, Sec. 773-(4-13) (h)). Said [fol. 14] Act permits a savings and loan association which is on a rotation basis, to sell new investments in savings-shareholder accounts, provided that the new deposits are withdrawable at will. Despite said proviso and in violation thereof, City Savings since 1959 has sold new depositor-shareholder investors' accounts on a restricted withdrawal basis, without compliance with any provision of the Savings & Loan Act necessary to permit new limited withdrawal capital investments, and has failed in all its advertising literature so sent through the mails, or otherwise, to disclose to prospective new purchasers of its securities, that it was on a limited withdrawal basis as to earlier accounts. These were material omissions causing the mailed circulars to be false and misleading and plaintiffs and the other new depositor-shareholders were misled in reliance thereon to purchase such securities issued by City Savings. Had such restrictions not been imposed by the Board of Directors and Mensik, the earlier investors, who then knew about Mensik's reputation to a greater or lesser extent, would have withdrawn all of their funds had they been able to do so.

22. The omission to state the material facts alleged above, which facts were necessary to be stated in order to make the statements made in said advertising circulars which served as the prospectus for the sale of said securities, in the light of the circumstances under which they

were made, not misleading, constitutes a violation by City Savings and the defendant officers and directors of City Savings of Section 10b of the Securities Exchange Act of 1934 (USC 78j(b)) and of Rule 10b-5 of the General Rules and Regulations under said Act.

23. As a result of the unlawful acts of defendant, City Savings, its officers and directors as above stated, more [fol. 15] than 5,000 investors have purchased securities of City Savings since July 23, 1959 in reliance upon such false and misleading representations sent to them through the United States mails by City Savings, each of which mailings omitted to state material facts as above alleged. These persons constitute a class and there is a common question of law and fact affecting the several rights of said persons, including plaintiffs, and common relief is sought hereby. Said persons are so numerous as to make it impractical to bring them all before the Court and plaintiffs will fairly insure the adequate representation of all of said persons. Plaintiffs bring this action on behalf of themselves and as a class action for and on behalf of said numerous other persons pursuant to Rule 23 of the Federal Rules of Civil Procedure. Plaintiffs state that the claims of plaintiffs and of all such other persons similarly situated aggregate between fifteen and twenty million dollars.

24. The assets of City Savings are in the custody of Defendant Joseph E. Knight as Director of the Department of Financial Institutions of the State of Illinois and of Defendant Justin Hulman, supervisor of the Savings and Loan Division of said Department. Defendant Mensik claims to hold valid proxies to vote approximately 90% of the outstanding shares of City Savings at the meeting of its shareholders to be held on July 28, 1964, and will vote said proxies in favor of a resolution to voluntarily liquidate City Savings pursuant to a voluntary plan of liquidation of City Savings proposed by Defendant Knight. Defendant Mensik further will vote the said proxies, which he claims to hold, in favor of the election of Defendants

Kwasman, Hartman, and Kirby as liquidators of City Savings.

[fol. 16] Wherefore plaintiffs pray:

1) For the entry of an order finding that all sales of depositor-withdrawable capital shares by City Savings since July 23, 1959 were and are void and that the purchasers of such securities are creditors of City Savings entitled to receive repayment of the purchase price paid for their respective depositor-withdrawable capital shares, including their depositor accounts, in the respective amounts paid by them for such securities, with interest thereon at the rate of 5% per annum from the respective dates they respectively purchased said securities from City Savings and paid City Savings therefor, less any amounts previously paid to them respectively, together with reasonable attorney's fees and costs of this suit.

2) For the entry of judgments in favor of plaintiffs and all other respective purchasers of such securities in the aggregate principal amount of twenty million dollars ($20,000,000.00), with interest on the judgment of each purchaser at five (5%) per centum per annum from the respective dates of purchase by each such purchaser who bought and paid for such securities on or after July 24, 1959.

3) That this Court temporarily and permanently restrain and enjoin each and all of the defendants from paying out any amounts of the assets or proceeds of assets of City Savings to any shareholder-depositor who purchased his depositor-shareholder account from City Savings prior to July 24, 1959, without first paying to plaintiffs and all other purchasers of depositor-shareholder accounts who made such purchases on or after July 24, 1959, the full refund of the purchase prices paid by them for such securities, plus such [fol. 17] interest. In the event that any of the defendants pay any amount to any depositor-shareholder for

shares acquired prior to July 24, 1959, without first paying in full those who acquired their depositor-shares on that date or thereafter, to the extent that any such payment is made out of assets of City Savings or the proceeds thereof, this Court enter personal judgment against the defendants and each of them and against the sureties on their respective official bonds, if any, heretofore or hereafter given by them for the faithful performance of their official duties with respect to the assets of City Savings.

4) That this Court order that the City Savings records of depositor-shareholder accounts disclosing each depositor-shareholder who purchased his or her securities of City Savings on or after July 24, 1964, stand as the proofs of claim of such depositor-shareholders as creditors of City Savings without the need for any other or further proofs of claim by any of them.

5) That this Court sequester out of the proceeds of this action and order paid to the attorneys for plaintiffs such amount as this Court finds to be reasonable as attorneys' fees for their services herein, commensurate with the nature, magnitude, and results of such services in this proceeding.

IN UNITED STATES DISTRICT COURT

MOTION OF DEFENDANTS DENNIS KIRBY, LOUIS KWASMAN, HARRY HARTMAN AND CITY SAVINGS ASSOCIATION TO STRIKE THE COMPLAINT AND TO DISMISS THE CAUSE OF ACTION OR, IN THE ALTERNATIVE, TO MAKE THE COMPLAINT MORE DEFINITE AND CERTAIN—Filed November 20, 1964

[fol. 18] Defendants Dennis Kirby, Louis Kwasman, Harry Hartman and City Savings Association move the Court as follows:

1. To dismiss the action because the complaint fails to state a claim against the defendants upon which relief can be granted.

2. To dismiss the action because the court lacks jurisdiction over the subject matter.

3. To dismiss the action because the complaint fails to state a cause of action under the sections of the Securities Exchange Act of 1934, as amended, under any of the provisions of said act referred to in the complaint or under any other provisions of said act or any of the rules in force promulgated thereunder.

4. To dismiss the action for the reason that the provisions of the Securities Exchange Act of 1934, as amended, do not apply to the withdrawable shares of the defendant City Savings Association, which is a savings and loan association organized under the Illinois Savings and Loan Act (Chapter 32 Ill. Rev. Stat., Section 701 et seq.).

5. To dismiss the complaint for the reason that it fails to state properly a class action within the provisions of Rule 23 (a) of the Federal Rules of Civil Procedure.

IN UNITED STATES DISTRICT COURT

MOTION OF DEFENDANTS KNIGHT AND HULMAN TO DISMISS, STRIKE OR MAKE MORE DEFINITE—Filed November 20, 1964

Now comes the defendants, Knight and Hulman, by their attorney, William G. Clark, Attorney General of the State of Illinois, and moves this honorable Court as follows:

1. To dismiss the complaint previously filed herein;

2. To strike the complaint previously filed herein;

3. To order the plaintiffs to make their complaint more definite.

[fol. 19] As grounds for the aforementioned Motion, the defendants, Knight and Hulman state as follows:

1. The alleged cause of action set forth in the complaint is barred by the Statute of Limitations.

2. The complaint should be dismissed, because the relief prayed for is improper.

3. The defendants named in the complaint are improper and should be dismissed.

4. The complaint does not state a cause of action.

5. Section 78q of the Securities Exchange Act of 1934 does not apply to the withdrawable share of a savings and loan association organized under the laws of the State of Illinois.

[fol. 19a]

IN UNITED STATES DISTRICT COURT

MOTION TO STRIKE THE COMPLAINT AND DISMISS THE CAUSE OF ACTION—Filed November 20, 1964

Now come the defendants, Robert Franz, Stanley Pasko, Robert M. Kramer, C. Oran Mensik, Joseph Talarico and Gloria Mensik Sprincz, by their duly authorized attorneys, and move this Court to strike the complaint of the [fol. 19b] plaintiffs and dismiss the cause of action for the following reasons:

1. The complaint fails to state a cause of action within the terms of Section 10 (b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j) and Rule 10B-5 promulgated thereunder because:

A. The plaintiffs fail to state facts upon which relief may be granted, and;

B. Said statutory sections do not apply to the withdrawable deposits in a savings and loan associ-

ation organized under the law of the State of Illinois.

2. The complaint fails properly to allege a class action within the provisions of Rule 23 (a) of the Federal Rules of Civil Procedure.

3. The complaint fails to identify with particularity the "sale literature" relied upon by plaintiffs in depositing their money in savings accounts with City Savings Association, which information is required to be set forth.

George S. Lavin, William P. Rosenthal, Leonard Schanfield, Henry M. Morris, Norman L. Rothenbaum, Attorneys for certain defendants, 110 South Dearborn Street, Chicago, Illinois 60603, CEntral 6-5622.

[fol. 19]

IN UNITED STATES DISTRICT COURT

ORDER—January 17, 1966

Defendants motions to dismiss the complaint or, in the alternative, to make the complaint more definite and certain are *denied*. Judge Campbell.

[fol. 21]

IN UNITED STATES DISTRICT COURT

ANSWER OF CITY SAVINGS ASSOCIATION, LOUIS KWASMAN, HARRY HARTMAN AND DENNIS KIRBY—Filed February 3, 1966

City Savings Association, Louis Kwasman, Harry Hartman and Dennis Kirby, defendants, for answer to the complaint of plaintiffs, state:

1. Defendants deny the allegations of paragraph 1 and specifically deny that this Court has jurisdiction under any statute.

2. Defendants admit that City Savings Association is a savings and loan association organized under the laws of the State of Illinois, but aver that on July 28, 1964, City Savings Association adopted a Plan of Voluntary Liquidation in accordance with the provisions of Article 9 of the Illinois Savings and Loan Act, Ill. Rev. Stat. ch. 32 § 901 et seq. (1965). Defendants Louis Kwasman, Harry Hartman and Dennis Kirby were duly elected and are acting as liquidators under said Plan of Voluntary Liquidation. Said Plan of Voluntary Liquidation was [fol. 22] approved by the Director of the Department of Financial Institutions of the State of Illinois, by a certificate duly recorded on August 7, 1964, in the office of the Recorder of Deeds of Cook County, Illinois as Document No. 19208434, whereupon said Plan of Voluntary Liquidation became effective as provided by § 9-4 of the said Illinois Savings and Loan Act. These defendants deny that City Savings Association issued or sold any securities to plaintiffs.

3. These defendants admit that at one time C. Oran Mensik was director, president, and principal executive officer of City Savings Association. These defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations that Mensik was director, president, and principal executive officer during all times material. Defendants deny that Mensik is now a director, president, or principal executive officer of City Savings Association.

4-8. These defendants admit that Robert M. Kramer, Stanley Pasko, Joseph Talarico, Jr., Gloria Mensik Sprincz, Robert Franz, and Herbert J. Hoover held at one time the offices or positions in City Savings Association alleged by plaintiffs, but deny that they hold said offices, or any office, at the present time. These defendants aver, on information and belief, that Herbert J. Hoover is now deceased.

9. These defendants admit that defendant Joseph E. Knight is Director of the Department of Financial Institutions of the State of Illinois and that prior to August 1, 1965 defendant Justin Hulman was the Supervisor of the Savings and Loan Division of said department. These defendants aver that by virtue of the provisions of Ill. Rev. Stat. ch. 32, § 841 et seq. (1965), which became effec- [fol. 23] tive August 1, 1965, the Illinois Savings and Loan Act was amended whereby an agency of the State of Illinois known as the Office of the Commissioner of Savings and Loan Associations was created and defendant Justin Hulman was duly appointed, qualified, and is now acting as Commissioner thereof. These defendants aver that the Office of the Commissioner of Savings and Loan Associations now has the same relationship to City Savings Association as the Director of Financial Institutions formerly had prior to the effective date of said amendatory Act.

10. These defendants admit that defendants Kwasman, Hartman, and Kirby were duly nominated as Liquidators of City Savings Association under a proposed Plan of Voluntary Liquidation. These defendants aver that said defendants Kwasman, Hartman, and Kirby were duly elected as liquidators at a meeting of the shareholders of City Savings Association duly held on July 28, 1964, at which meeting a Plan of Voluntary Liquidation for City Savings Association was duly adopted in accordance with the provisions of Article 9 of the Illinois Savings and Loan Act. These defendants admit that defendants Hartman and Kirby are employees of the State of Illinois but deny the remaining allegations of paragraph 10.

11. These defendants admit that the plaintiffs named in paragraph 11 made deposits at City Savings Association in the amounts set forth and on the dates indicated in paragraph 11. These defendants deny the remaining allegations of paragraph 11 and specifically deny that the plaintiffs indicated, or any other persons, made purchases of securities from City Savings Association.

12. These defendants deny that any purchases whatever were made by plaintiffs or any of them. These de- [fol. 24] fendants lack information sufficient to form a belief as to the truth of the allegations as to the motivation for plaintiffs' activities.

13. These defendants admit that quoted in paragraph 13 are excerpts from Rule 10b-5 of the General Rules and Regulations promulgated under § 10(b) of the Securities Exchange Act of 1934. These defendants deny the remaining allegations of paragraph 13.

14. These defendants admit the allegations of paragraph 14.

15. These defendants deny the allegations of paragraph 15.

16. These defendants admit the allegations of paragraph 16, except that they aver that Mensik's domination and control of City Savings Association ceased temporarily during a period in 1957 when City Savings Association was placed under the custody and control of the Auditor of Public Accounts of the State of Illinois, and ceased permanently on or about June 30, 1964 when City Savings Association was again placed under the custody of the Director of the Department of Financial Institutions of the State of Illinois, whose functions have since been assumed by the Commissioner of Savings and Loan Associations of the State of Illinois as of August 1, 1965.

17. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 17.

18. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 18.

19. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 19 and specifically lack information sufficient to form a belief [fol. 25] as to the truth of the allegation that Mensik's

name was concealed and as to the allegation of the effect disclosure of Mensik's name would have had.

20. These defendants lack information sufficient to form a belief as to the truth of the allegations pertaining to the sales literature purportedly sent out on behalf of City Savings Association and the representations or omissions contained therein. These defendants admit that the Director of the Department of Financial Institutions of the State of Illinois took custody of the assets of City Savings Association on or about June 30, 1964. These defendants lack information sufficient to form a belief as to the truth of the allegations as to the date that plaintiffs learned of Mensik's connection with City Savings Association.

21. For answer to the allegations of paragraph 21, these defendants deny that City Savings Association had commitments as alleged in plaintiffs' complaint, and deny that any commitments purporting to have been made by City Savings Association were, in fact, binding obligations. These defendants admit that at one time there was a limitation imposed by the Board of Directors of City Savings Association as to the amount of money which its depositors could withdraw. These defendants deny that there are $12,000,000 of withdrawable capital on a "rotation" basis, or on any other withdrawable basis, for the reason that the City Savings Association is now in liquidation and no withdrawals have been permitted. These defendants admit that the Savings and Loan Act (Smith-Hurd, Ill. Rev. Stats. ch. 32 §901 et seq.) was revised. These defendants deny the remaining allegations of paragraph 21 not herein specifically admitted.

22. These defendants deny the allegations of paragraph 22.

[fol. 26] 23. These defendants deny the allegations of paragraph 23.

24. The allegations of paragraph 24 are now moot. Defendant City Savings Association is in the process of voluntary liquidation as alleged in paragraph 2 above.

25. For a further and affirmative defense these defendants aver that plaintiffs' complaint fails to state a cause of action or to state a claim upon which relief can be granted in that the deposits made by plaintiffs do not constitute a security within the meaning and intent of Section 29(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78cc(b)] or of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)], and in that Section 29(b) of the Securities Exchange Act of 1934 does not provide a remedy to these plaintiffs under the circumstances as set forth in the complaint.

26. For a further and affirmative defense these defendants aver that plaintiffs do not represent a class, that they do not plead the requisites of a class action, and further, that plaintiffs have failed to comply with the provisions of Rule 23 of the Federal Rules of Civil Procedure in that (a) the parties are not so numerous as to make it impractical to bring them all before the Court, but on the contrary aver by intervention, or otherwise, an overwhelming preponderance of the depositors have become parties to this action, and (b) there is no common question of law and fact affecting the several rights of the parties, but on the contrary the rights of each of the plaintiffs are separate and distinct, depending upon the so-called representations made to each plaintiff and his reliance and right to rely thereupon. Accordingly, plaintiffs represent only themselves.

[fol. 27] 27. For a further and affirmative defense these defendants aver that defendant City Savings Association is now in the process of voluntary liquidation under the Illinois Savings and Loan Act and was subject to the supervision and direction of the Director of the Department of Financial Institutions of the State of Illinois until August

1, 1965, and thereafter has been subject to the supervision and examination of the Commissioner of Savings and Loan Associations of the State of Illinois. The State of Illinois, acting through its agencies mentioned above, has exclusive jurisdiction over all matters pertaining to the liquidation, including the claims, if any, of plaintiffs herein. Pursuant to the provisions of Section 9-7 of the Illinois Savings and Loan Act, plaintiffs' claims are required to be presented initially to the liquidators, whose function, among others, is to determine the relative rights of creditors and depositors. Under that Section, no depositor shall be given a preference by any method until after the liquidators have made a determination as to the relative priorities. The purpose of plaintiffs' claims herein is to give them a preference over other depositors. Because the plaintiffs have not presented their claims to the liquidators; and because the liquidators have not made a final determination as to the relative priorities, the plaintiffs have not suffered any injury and their resort to this Court is untimely and premature. Plaintiffs have failed to exhaust their administrative remedies and their action should be dismissed.

28. For a further and affirmative defense these defendants aver that plaintiffs are guilty of laches.

29. For a further and affirmative defense these defendants aver that plaintiffs' claims are barred by the statute of limitations.

[fol. 28] Wherefore, defendants City Savings Association, Louis Kwasman, Harry Hartman and Dennis Kirby pray that the complaint of plaintiffs be dismissed and that they have judgment for their costs.

In United States District Court

Answer of Defendants Knight and Hulman—Filed February 3, 1966

Now comes Defendants, Joseph E. Knight, Director of Department of Financial Institutions of the State of Illinois and Justin Hulman, Supervisor Savings and Loan Division of said Department by William G. Clark, Attorney General of the State of Illinois, their attorney and make Answer to Plaintiffs' complaint filed herein, as follows:

1. Deny each and every allegation in Paragraph "1" except admit the existence of such Statute and that plaintiffs purport to base the jurisdiction of this court upon such Statute, although deny that this court has jurisdiction under any statute.

2. Deny each and every allegation of the last sentence of Paragraph "2" except admit the remaining allegation of said paragraph. In further answer defendants deny that any securities are involved in this claim within the meaning and intent of the Securities Exchange Act of 1934 (15 USC § 78aa) and SEC Rules thereunder.

3. Deny knowledge or information sufficient to form a belief as to each and every allegation in Paragraphs "3," "4," "5," "6," "7," and "8," except admit that the persons listed in said paragraphs were at one time or other connected with City Savings Association.

4. Admit the allegations in paragraph "9" as of the date of filing the complaint herein but allege that presently the official capacities of defendants Knight and Hulman have been reclassified by Illinois law regarding savings and loan associations in so far as defendant Hulman [fol. 29] is the Commissioner of Savings and Loan Association of the State of Illinois and defendant Knight is presently divested of any authority or control of savings and loan associations which are under the State of Illinois supervision.

5. Deny each and every allegation of Paragraph "10" except admit that defendants Kwasman, Hartman and Kirby were nominated as liquidators of City Savings Association under a plan of voluntary liquidation. In further answer defendants Kwasman, Hartman and Kirby were duly elected as liquidators at a meeting of depositors of City Savings Association held on July 28, 1964 (which occurred subsequent to the filing of the complaint herein) at which meeting a plan of voluntary liquidation for City Savings Association was duly adopted in accordance with the provisions of the Illinois Savings and Loan Act, Article 9. Further answering defendants Hartman and Kirby were employees of the Illinois Department of Financial Institutions but are now employed by the Illinois Office of the Commissioner of Savings and Loans Associations.

6. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "11" and further allege that no securities are involved within the meaning and intent of the Securities Exchange Act of 1934 (15 USC 78aa) and SEC Rules thereunder.

7. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraphs "12," "17," "18," "19," and "23".

8. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "13" and "14" except admit the existence and substance of Rule 10 (b)-5 and Section 29 (b) of the Section 29 (b) of the [fol. 30] Securities Exchange Act of 1934 (15 USC Section 78cc (b)) but such rule and statutory provision have no application to defendants herein.

9. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "15". Further answering allege that no securities are involved within the meaning and intent of the Securities Exchange Act of 1934 (15 USC 78aa) and SEC Rules thereunder.

10. Deny knowledge or information sufficient to form a belief as to each and every allegation of paragraph "16" except admit on information and belief that defendant Mensik participated in the operation of City Savings Association.

11. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "20" except on information and belief admit that City Savings Association had been denied insurance of accounts by the Federal Home Loan Bank Board and that defendant Knight, Director of Financial Institutions of the State of Illinois took custody of City Savings Association on or about June 30, 1964.

12. Deny knowledge or information sufficient to form a belief as to each and every allegation of paragraph "21". Further answering admits that at one time there was a limitation imposed by the Board of Directors of City Savings Association as to the amount of money which its depositors could withdraw. In further answer deny that there are $12,000,000 of withdrawable capital on a "rotation" basis, or on any other withdrawable basis, for the reason that the City Savings Association is now in liquidation and no withdrawals have been permitted. These defendants admit that the Savings and Loan Act (Smith-[fol. 31] Hurd, Ill. Rev. Stats. Chapter 32, Section 901 *et seq.*) was revised.

13. Deny each and every allegation of paragraph "22".

14. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "24" except admit the first sentence of said paragraph, but only as to defendant Hulman as of this time since in further answer defendant Knight, who formerly controlled the Savings and Loan Division of the Illinois Department of Financial Institutions no longer has such authority under Illinois law. On information and belief defendant Mensik, had a substantial number of proxies and voted said

proxies in favor of the plan for voluntary liquidation after the filing of this complaint herein.

First Affirmative Defense of Defendants Knight and Hulman

15. For a first affirmative defense allege the complaint fails to state a claim against defendants upon which relief can be granted.

Second Affirmative Defense of Defendants Knight and Hulman

16. For a second affirmative defense allege that this court lacks jurisdiction over the subject matter of this alleged claim since there is no claim under any federal statute.

Third Affirmative Defense of Defendants Knight and Hulman

17. For a third affirmative defense allege that this court lacks jurisdiction over the person of these defendants since they are being sued in their official capacity as a state officer and is therefore a claim against the State of Illinois which is barred.

[fol. 32]

Fourth Affirmative Defense of Defendants Knight and Hulman

18. For a fourth affirmative defense allege that defendants are not proper parties to this claim and cannot be sued or made defendants in this alleged claim.

Fifth Affirmative Defense of Defendants Knight and Hulman

19. For a fifth affirmative defense alleged that the alleged claim is barred by the Statute of Limitations.

Sixth Affirmative Defense of Defendants Knight and Hulman

20. For a sixth affirmative defense allege that the alleged claim is barred by laches.

Seventh Affirmative Defense of Defendants Knight and Hulman

21. For a seventh affirmative defense allege that the plaintiffs have brought this claim in bad faith and without doing equity but yet invoking this court's equitable powers and are therefore estopped.

Eighth Affirmative Defense of Defendants Knight and Hulman

22. For an eighth affirmative defense allege that the relief prayed for in the complaint is not supported by any allegations against these defendants.

Ninth Affirmative Defense of Defendants Knight and Hulman

23. On information and belief for a ninth affirmative defense allege that the alleged claim is barred since plaintiffs had their proxies voted in favor of the plan for voluntary liquidation and cannot seek a preferred position over other depositors.

[fol. 33]

Tenth Affirmative Defense of Defendants Knight and Hulman

24. On information and belief for a tenth affirmative defense allege that plaintiffs by having their proxies voted in favor of the plan for voluntary liquidation have ratified and affirmed the acts of defendants which are complained of in the complaint.

Eleventh Affirmative Defense of Defendants Knight and Hulman

25. On information and belief for an eleventh affirmative defense allege that plaintiffs do not represent a class, that they do not plead the requisites of a class action, and further, that plaintiffs have failed to comply with the provisions of Rule 23 of the Federal Rules of Civil Procedure in that (a) the parties are not so numerous as to make it impractical to bring them all before the Court, but on the contrary allege by intervention, or otherwise, an overwhelming preponderance of the depositors have become parties to this action, and (b) there is no common question of law and fact affecting the several rights of the parties, but on the contrary the rights of each of the plaintiffs are separate and distinct, depending upon the so-called representations made to each plaintiff and his reliance and right to rely thereupon. Accordingly plaintiffs represent only themselves.

Wherefore, Defendant Knight and Hulman demand judgment in their favor and against plaintiffs and that the complaint be dismissed together with costs, expenses and disbursements of this action to be paid for by plaintiffs.

[fol. 34]

In United States District Court

Memorandum and Order—March 22, 1966

Plaintiffs are presently before the court on a motion seeking the appointment of a receiver.

Since I assumed jurisdiction in this case on January 17, 1966 I have had the benefit of extensive oral argument by the many able attorneys representing the various parties. Additional briefs and pleadings, in the main addressed to the present motion for the appointment of a receiver, have been filed and I have had the opportunity to review ex-

tensively the Peat, Marwick, Mitchell and Company April 30, 1964 Audit report, which prior to my order of February 21, 1966 (Transcript of Proceedings, February 21, 1966, p. 24) was filed of record but impounded. On the basis of this exhaustive review of what conservatively can be characterized as a most complex and extensive matter —both factually and legally—I make the following observations in deciding the pending motion.

When initially making my decision to assume jurisdiction over this case I was faced with deciding what I acknowledged to be a difficult, far reaching and close legal issue of first impression. I refer to the issue of whether or not Illinois savings and loan depositors or investors enter into an investment contract and in effect are purchasers of securities within the meaning and provisions of the Exchange Act. 15 U.S.C. 78a, *et seq.*

Normally, when making such an important interlocutory decision without the benefit of some prior judicial authorities, preferably from our own Seventh Circuit, I have looked with favor upon motions requesting a §1292(b) interlocutory appeal. (*Radiant Burners Inc.* v. *American Gas Association et al,* 207 F. Supp. 771 and 209 F. Supp. 321, Rev. in 320 F2d 314, cert. den. 375 U.S. 929.) However, in the instant case I denied defendants' motions requesting [fol. 35] permission to file such an interlocutory appeal. In denying defendants' motions I explained that my main concern was the plight of the individual investors. (Transcript of Proceedings, January 21, 1966, pp. 17-20)

Then, as now, their protection and the expeditious resolution of all of the issues presently standing in the way of a final and fair total liquidation of City Savings and Loan Association was my objective. I was then impressed, as I am now even more impressed, with what appears to be a confusion in efforts, possible conflicting interests, and the possible resulting subjugating of investors' claims to the interests of others. A final and total resolution and payment of investors claims appears long overdue.

Plaintiffs, certainly not by design, by their present motion for appointment of a receiver place an additional burden and obstacle in the way of my expediting this matter. The mere granting of the motion and appointment of a receiver—standing alone—would, of course, cause no additional delay, for that matter I believe the converse would result; the resolution of the cause would most probably be expedited. However, the granting of the motion would necessarily, and quite properly, serve to permit defendants the interlocutory appeal heretofore denied them. (Title 28 U.S.C.A. §1292(a)(2)) The delay I sought to preclude with thus prove unavoidable.

Accepting this necessary result, delay, albeit procedurally proper, is inevitable. The main cause for my denying defendants' earlier motions for interlocutory appeal is therefore no longer controlling.

A motion in Federal Court for the appointment of a receiver should be granted only under the extremest of [fol. 36] circumstances. In *Connolly* v. *Gishwiller,* 162 F2d 428 our Seventh Circuit Court of Appeals, although affirming the lower court's appointment of a receiver stated: "It is true, of course, the power to appoint a Receiver is a drastic, harsh and dangerous one and should be exercised with care and caution". (*Connolly* p. 435) See also *Mintzer* v. *Arthur L. Wright Co.,* 263 F2d 823; *Chambers* v. *Blickly Ford Sales, Inc.,* 313 F2d 252.

Also, where as here, state law provides adequate means for affording sufficient protection of assets, federal courts should be most hesitant to assert themselves by way of receivership. *Pennsylvania* v. *Williams,* 294 U.S. 176; *Fulia* v. *Warranty Bldg. and Loan Assn.,* 5 F. Supp. 952.

Plaintiffs' complaint, briefs and most importantly their affidavits allege nothing less than fraud on the part of the present liquidators, those over whom or in lieu of a court appointed receiver would act. On the basis of plaintiff's allegations the present liquidators are either corrupt, inefficient or both. To this extent the circumstances here

might be distinguished from *Pennsylvania* v. *Williams* cited above. However, as is most often the case, these allegations are for the most part general and not specific. Although possibly susceptible of proof at an extended hearing or trial, these general allegations do not warrant my granting the extraordinary relief sought, especially where as here I am in the first instance proceeding upon legally tenuous jurisdictional grounds. Rather than compound the legal uncertainty of my rulings I must deny the present motion for appointment of a receiver. As already stated this determination is further indicated by the necessary elimination of what I expressed to have been the overriding salutary purpose of my prior rulings; the expeditious resolution of the investors claims.

[fol. 37] Accordingly, I deny plaintiffs' motion for the appointment of a receiver. Recognizing the consequences of this ruling I do hereby certify that my order denying this motion ". . . involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation . . .". (Title 28 U.S.C. §1294(b))

Further, on my own motion and for the reasons detailed above I now certify that my Order of January 17, 1966 assuming jurisdiction over this case and in effect holding that withdrawable capital shares in a savings and loan association are securities within the meaning of the Exchange Act also ". . . involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation . . .". (Title 28 U.S.C. 1294(b))

Pending resolution of what I anticipate will be immediately filed appeals, this court in no way restrains the liquidation proceedings presently pending or hereafter commenced in the State Court. Should, however, this court be sustained in its jurisdictional ruling those proceedings

will, of course, be most carefully reviewed and analyzed in detail.

In its present posture I express the hope that my ruling on the main issue concerning the scope and meaning of the term "security" will be reviewed and the law of this Circuit determined by our Seventh Circuit Court of Appeals. Should that learned court agree with my resolution of this issue I can then entertain another motion for appointment of a receiver, assuming such relief is still available. [fol. 38] (See *Esbitt* v. *Dutch-American Mercantile Corp.*, 335 F2d 141) Should it determine I am in error in such resolution then all issues herein, including that seeking appointment of a receiver become moot.

Judge Campbell.

[fol. 39] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 40]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Nos. 15631, 15633 and 15634

No. 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

ROBERT FRANZ, et al., Defendants-Appellants.

No. 15633

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN and LOUIS KWASMAN, Defendants-Appellants.

No. 15631

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

JOSEPH E. KNIGHT and JUSTIN HULMAN, Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

No. 64-C-1285

Honorable William J. Campbell, Chief Judge, Judge Presiding.

Plaintiffs-Appellees' Appendix—Filed September 14, 1966

[File endorsement omitted]

[fol. 41] Prepared in abstract and narrative form as a condensation of original documents used in the District Court, of which Plaintiffs-Appellees have filed three copies each pursuant to Rule 18 of this Court. All counsel either had or were served with copies in that Court. (These documents are referred to only at pp. 6, 15, 39, including footnote, and 41 of Plaintiffs-Appellees' Brief. Except for the proxy and letter which are the subject of the reference to the Record at p. 6 of Plaintiffs-Appellees' Brief, the documents abstracted herein have been carefully identified at pp. 15 and 39 of that Brief, for the convenience of this Court and all parties.)

Exhibit 1 filed 6-25-65 in District Court. 370 sheets, names and addresses of investors in City Savings Association. Included are 21 sheets stapled together in Envelope No. 2 of Exhibit 1, showing investors in 43 states, the District of Columbia and foreign countries. (Referred to at p. 39, Plaintiffs-Appellees' Brief.)

Exhibit "C" follows (Record p. 577). Notice of Special Shareholders' Meeting of City Savings Association called for 7/14/64 to vote on proposal to liquidate the Association and appoint liquidation committee. Shareholders unable to be present and who do not have proxy on file with the Assn. requested to sign and return enclosed proxy. (Referred to at p. 6, Plaintiffs-Appellees' Brief.)

Exhibit "D", Form of shareholder's proxy of City Savings Assn. Contains blanks for signature of shareholder and for account number. Appoints officers or a majority of them to vote at any meeting of shareholders. Recites "unless revoked" the proxy is to operate while shareholder continues as such, and "if revoked" revocation applies [fol. 42] only to meeting for or at which "right to revoke" is exercised. (Referred to at p. 6, Plaintiffs-Appellees' Brief.)

Affidavit of George L. Weisbard, C. P. A. Feb. 12, 1966 (Record pp. 545-570). (Referred to at pp. 15, including footnote, and 41 of Plaintiffs-Appellees' Brief.)

Numerous practices and activities of City Savings appear unlawful under Ill. Sav. and Loan Act, including:

1. *Unauthorized investments.*

While the Association was operating under Sec. 4-13 of the Act and limiting withdrawals, about $9½ million of unlawful investments were made.

2. *Improper extensions of loans.*

Extensions of past due loans were granted, although prohibited by the Act during any period while the Association was operating with unpaid withdrawal demands pending.

3. *Illegal purchases of mortgages.*

4. *Inadequate reserves.*

At no time from 1959 through 1963 were minimum statutory reserves maintained. Thus, unlawful dividends were paid.

5. *Accounting violations.*

Proper accounting principles were not followed, in that unearned discounts and commissions were treated as current income instead of being amortized over a period of years, while advertising expenses which should not have been amortized were improperly deferred and were not deducted from current income.

6. *By-passing the Rotation limitations requiring pro-rata treatment of withdrawing Shareholders.*

[fol. 43] 7. *Failure to keep proper minutes.*

8. From July 1, 1958 through Dec. 31, 1963 violations of limitations on withdrawal provisions of the Act occurred.

Excess pay-outs through the loan device aggregated almost $5 million through 1963.

From Jan. 1, 1959 to June 30, 1964 the Association recorded as income about $3½ million of premiums on loans which sound accounting practice required to be deferred

to the extent that they exceeded the cost of placing the related loans on the books.

It appears that no payments were ever received on these loans and that excessive commissions were charged on the same money by shifting the liability to different loan numbers, resulting in an overstatement of income and assets in each year.

9. *Impairment of capital at December 14, 1963.*

Excessive loans as compared to value of property mortgaged.

Estimated excess of loans over fair value of underlying security at June 30, 1964 $16½ million so that indicated impairment after crediting reserves and undivided profits was $15¾ million.

10. At no time from July 24, 1959 to June 30, 1964, when State took custody of the Assn. were sufficient reserves maintained. The overstatement of income was used to pay unearned dividends.

The pre-July 1959 depositors in substantial measure were paid out of the pockets of post-July 23, 1959 depositors.

Necessary effective controls over pay-outs of escrow accounts were lacking. Records were inadequate. Waivers of liens were missing. Improvements in records and controls previously recommended by the auditor of the Assn. had not been made.

[fol. 44] The report prepared by the Assn.'s C. P. A., dated May 11, 1964, analyzed the annual reports of the Association for years 1959 through 1963. It disclosed that unearned income had been recorded.

11. The schedule attached to the Weisbard Affidavit of February 12th indicated that the estimated maximum realizable value of all assets of City Savings Association is about $10¼ million as against withdrawable capital shares of over $27⅓ million.

The Statement of Condition shows no liability for real estate taxes for 1962 or 1963.

SUPPLEMENTARY AFFIDAVIT OF GEORGE L. WEISBARD, C. P. A. —March 9, 1966. (Record pp. 847-872). (Referred to at pp. 15, including footnote, and 41 of Plaintiffs-Appellees' Brief.)

George L. Weisbard is a C. P. A. and an attorney at law, admitted to the New York, Michigan and Illinois bars for over 20 years. The report of examination of the books of City Savings Association at June 30, 1964 by Theodore E. Weinberg does not purport to be and is nothing more than a reflection of the Association's books. It contains nothing which would change the accounting conclusions reached by Peat, Marwick, Mitchell & Co. or by Mr. Weisbard in his Affidavit of February 12, 1966.

The Weinberg report is not an audit. The Statement of Operations therein includes as 1964 income all commissions charged on loans made during the six-month period covered by that statement. Generally accepted accounting principles and regulations of the Illinois Department of Financial Institutions require that commissions on loans, in excess of cost of putting the loans on the books, be amortized over the life of the loan. In the six-month period the amortization should have been $50,000, so that income [fol. 45] was overstated by about $460,000 by reason of those commissions alone.

The Weinberg report refers to a letter to shareholders of City Savings. (Exhibit "C", referred to in this appendix.)

It was misleading because:

a. The term "voluntary liquidation" was used loosely.

b. It implied that the shareholders would receive 100 cents on the dollar in liquidation which was untrue.

c. It implied that the Association was able to pay a dividend, although there was no cash to pay any dividend.

d. Statement that $89,000 remained in undivided profits after the dividend was untrue.

e. The reason stated for going out of business was false. In truth, the bulk of loans were being refinanced

instead of collected and the payments from the remaining loans were insufficient to meet payroll and operating expenses.

f. Since the Association was not meeting withdrawal requests through profits and was receiving no cash payment on almost $27 million of its $32 million in loans the cash withdrawn in excess of receipts from the remaining $5 million of loans, about $10¼ million since July 24, 1959, must have come from new depositors (see Schedule II appearing at R. 859).

g. The voluntary plan would be supervised by the depositors themselves, which was untrue.

h. The Peat, Marwick, Mitchell & Co. report was not disclosed.

The Weinberg report also included a notice of a special meeting of shareholders to be held 7/28/64. It did not refute the misleading statements in the prior letter per- [fol. 46] taining to the meeting originally set for 7/14/64. It contained at least 8 misrepresentations cited by Mr. Weisbard including that the liquidation was voluntary, without disclosure that it was forced by the Department of Financial Institutions.

A purported letter, of June 25, 1964, discloses that Defendants Knight and Hulman believed then that "the individual shareholders of the Assn. will suffer a substantial loss if the Assn. is closed." Peat, Marwick, Mitchell & Co. undertook to verify the value of the assets of City Savings in preparing their report.

Property referred to in the Weinberg report included 48 improved properties carried at cost "which was frequently in excess of fair market value." These represented ⅔rds of the properties owned by the Assn. The fixed asset account failed to recognize that $367,800 had been overpaid for remodelling City Saving's headquarters, as found by the U. S. Tax Court, 37 T. C. 703.

Almost $6 million to be disbursed represents commitments in excess of cash available and in so-called escrow

accounts. The Peat, Marwick report and the Mize audit indicate that escrow accounts were not actually maintained, so the Weinberg report as to amounts in escrow accounts is inaccurate in that the funds were either nonexistent or had been misappropriated.

Weinberg report omitted liability for 1963 and 1964 real estate taxes from the statement of condition. The reserve for uncollected interest was understated because of unlawful refinancing of delinquent loans, thereby adding uncollected interest to the original loan and inflating receivables and income.

Sec. 4-13 of the Ill. Sav. & Loan Act had been violated in making share loans, which were extinguished by being offset against shareholder accounts in violation of the [fol. 47] priority rotation system required by the Ill. Act. Advertising issued by the Assn. stated that it was "Under State Government Supervision" as illustrated by Exhibits "B", "C", and "D", being circulars issued in 1962, 1963 and 1964.

PEAT, MARWICK, MITCHELL & CO.'s SPECIAL REPORT in re City Savings Association, as at April 30, 1964, to the Illinois Director of Financial Institutions on June 15, 1964.

(This report was transmitted to the Court of Appeals on August 19, 1966 under the certification of the Clerk of the United States District Court of the Northern District of Illinois. At request of Defendant Liquidators, this document was impounded by Judge Igoe on June 25, 1965. Impounding order was lifted on February 21, 1966 by order of Judge Campbell. Because no record page numbers appear thereon, the page numbers herein below set forth refer to the paging of the document. The matters contained in this Report are referred to at p. 15 of Plaintiffs-Appellees' Brief.)

Letter report, June 15, 1964, addressed Director, Department of Financial Institutions. Reports to Director as of April 30, 1964 on the analysis of books of account and accounting procedures of City Savings.

Mr. Mize, the CPA of City Savings, did not render an opinion as to the condition of the Assn. as of 12/31/63. Based on the Peat, Marwick analysis of the Assn.'s records, the Director of the Department of Financial Institutions had reason to take custody of the Assn. under Sec. 7-8 of the Illinois Savings and Loan Act for the following reasons:

(1) Withdrawable capital impaired; insufficient to pay in full creditors and holders of withdrawable capital;

[fol. 48] (2) The business of the Assn. was being conducted in an unsafe manner;

a. Dividends for 1963 were about $125,000 in excess of net income and accumulated undivided profits, and the earnings during four months of 1964 were $50,000 less than estimated dividend requirements;

b. During 1963 the contingent reserve was reduced by about $127,000 instead of being increased by $87,000 as required by the Illinois Act.

d. The test appraisals of real estate made by the qualified independent appraiser for the purpose of the Peat, Marwick report indicate that the security is not good and ample for the loans, as required by the Illinois Act.

The Assn. has not followed generally accepted accounting principles in its treatment of advertising expenses and premiums on loans. Internal controls for the year 1963 were inadequate in various specific ways detailed at page 3 of the Peat, Marwick Report.

As of April 30, 1964 a reasonable estimate of the impairment of capital is over $14⅓ million arising because of excessive book values of loans over current appraisal values, and because of five other listed causes.

82% of the total portfolio of mortgage loans went into two development projects, Apple Orchard at Bartlett, Illinois, and Howie in the Hills, Hoffman Estates, Illinois. This represents a large concentration of risk.

Since January 14, 1959, when Apple Orchard was started, and October 5, 1960, when Howie-in the Hills was started, the Assn. has financed and refinanced the same properties to the extent of $64¼ million.

In the categories of both real estate owned and real estate in judgment subject to redemption the cost was [fol. 49] in excess of current realizable value, involving an aggregate of 145 parcels. The promotional items on hand did not amount to any appreciable inventory and there was no valid reason for a financial institution to defer $373,392 of advertising expenses. This amount constitutes an impairment of assets.

Escrow agreements and other supporting evidence for the payout of funds from escrow accounts were missing in many cases. Management had a policy of disposing of all supporting data up to the date of the last State examination. Upon inquiry for data supporting pay-outs subsequent to the last State examination no adequate documents were produced.

Loans in Process Records followed a pattern similar to the escrow accounts.

Appendix B to the Peat, Marwick Special Report contains a list of pay-outs for which there were no supporting documents totaling almost $2,000,000.

The premiums on loans treated as income in each year 1958 to 1964 were in excess of related costs and should not have been treated as income in the years so treated.

As to American Fidelity Insurance Co. Ltd., to which references were made in the Peat, Marwick Report at Appendix A, the Illinois Department of Insurance reports that it has no record of this company being licensed to operate in Illinois.

[fol. 50] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 51]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

September Term, 1966—January Session, 1967

No. 15631

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

JOSEPH E. KNIGHT and JUSTIN HULMAN,
Defendants-Appellants.

No. 15633

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN and LOUIS KWASMAN, Defendants-Appellants.

No. 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

ROBERT FRANZ, et al., Defendants-Appellants.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.

OPINION—January 20, 1967

Before Knoch, Kiley and Cummings, Circuit Judges.

Knoch, Circuit Judge. The City Savings Association, an Illinois savings and loan association, is now in process [fol. 52] of voluntary liquidation. When this Complaint

was filed in the United States District Court, the Association was in the custody of the defendant, Joseph E. Knight, Director of Financial Institutions of the State of Illinois. He had assumed custody on June 26, 1964, under authority of the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32 §848. The defendant Justin Hulman is the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.

At a special meeting on July 28, 1964, the shareholders of City Savings approved a plan of voluntary liquidation and elected the defendants Louis Kwasman, Harry Hartman and Dennis Kirby liquidators to carry out the plan which was approved by the Department of Financial Institutions as evidenced by a certificate filed with the Cook County Recorder of Deeds on August 7, 1964, at which time the plan became effective.

Meanwhile, on July 24, 1964, this action was filed by the plaintiffs-appellees, Alexander Tcherepnin, Ming Tcherepnin, et al., who describe themselves as purchasers, at various dates, of securities issued by City Savings, consisting of capital shares of and a capital interest in City Savings.

Under the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32, §§701-944, an association unable to meet its cash commitments could limit the amount of cash a depositor might withdraw [§773(b)] as City Savings did in 1958. It was then prohibited from accepting new deposits. The Act was amended on July 9, 1959 [§773(h)] to allow acceptance of new deposits on which it was prohibited to place limitations of withdrawal.

The accounts represented by the plaintiffs according to the Complaint were all opened under the 1959 amendments and hence are fully withdrawable despite the conclusory assertions in the Complaint that plaintiffs purchased their shares on a restricted withdrawal basis.

The plaintiffs brought this action for themselves and all other persons who made deposits in City Savings since

July 23, 1959, to have their purchases of shares declared void and to be declared creditors of City Savings. [fol. 53] They invoked jurisdiction of the District Court under §27 of the Securities Exchange Act of 1934 (Title 15, U.S.C. §78aa). Diversity of citizenship is lacking here. In addition to those noted above, the Complaint lists as defendants: the City Savings Association, and certain of its former officers and directors.

The Securities and Exchange Commission was allowed to intervene as amicus curiae. A group purporting to represent other depositors was allowed to enter the case as party-defendants.

The Complaint alleged that in making their deposits the plaintiffs relied on false and misleading solicitations mailed to them in violation of §10(b) of the Securities Exchange Act of 1934, and of the General Rules and Regulations promulgated thereunder, which rendered their purchases void under §29(b) of the Act entitling them to rescind their investments and to recover the amount of their investments plus interest.

The defendants City Savings and the three liquidators moved to dismiss the Complaint for lack of jurisdiction in the District Court because the subjects of the action —withdrawable capital accounts of a state-chartered savings and loan association—were not "securities" within the meaning of the Act. The other defendants also moved to dismiss the action. All the motions were denied.

The question presented by denial of motion to dismiss was certified by the District Court under §1292(b) of the Judicial Code (Title 18 U.S.C. §1292(b)). This Court granted petition for leave to file interlocutory appeal.

We are thus presented with one contested issue: is a withdrawable capital account in an Illinois-chartered savings and loan association a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934?

The plaintiffs-appellees and the Securities and Exchange Commission, which has filed its brief in these cases as

amicus curiae, both assure us that a withdrawable capital account in an Illinois-chartered savings and loan association is such a "security"; that Congress intended to [fol. 54] include such accounts within the broad definition of the Act, particularly as shown by subsequent amendments. They also point to court decisions classifying as "securities" some interests which possess some similar characteristics, which they view as the fundamental characteristics of these accounts. On the other hand, they see the other rather strikingly distinctive characteristics of these accounts, on which the appellants rely, as not fundamental but as merely subsidiary, some of even these being also present in other interests which have been accepted as securities.

The Act provides the following definition of a "security":

> "The term 'security' means any note, stock, treasury stock, bond debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a security; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." Securities Exchange Act of 1934, §3(a)(10), 15 U.S.C. §78c(a)(10)

The type of interest now before us, if it is covered by this definition, must be "an instrument commonly known as a security."

The report accompanying the predecessor Act, cited as the Securities Act of 1933, noted that the term "security" was so defined as to include the many types of instruments which in the commercial world fell within the "ordinary concept of a security." H.R. Rep. No. 85, 73rd Cong., 1st Sess. 5/4/33 p. 11.

[fol. 55] As appellants state, these accounts are unlike the ordinary concept of a security in such characteristics as being permissibly issued in unlimited amounts; as not made subject to the securities article of the Uniform Commercial Code; as not negotiable and transferable only by assignment; as subject to forced redemption and retirement on call of the board of directors; as fully matured and withdrawable when issued; as without preemptive rights; as evidenced by an account book, the holders of which are not entitled to inspect the general books and records of the association; although entitled to vote for directors, to give a proxy which may (and usually does) provide that it is irrevocable, and which is typically executed when the account is opened, and to receive dividends.

The Illinois statutes which created withdrawable accounts in savings and loan associations show clearly that the Illinois legislature did not intend them to be securities. It thus seems difficult to assert that these interests can be "commonly known as a security."

According to its preamble, the Securities Exchange Act is designed to regulate transactions in securities as commonly conducted on securities exchanges and over-the-counter markets, the price of such securities being susceptible to manipulation and control and the dissemination of such prices giving rise to excessive speculation resulting in sudden and unreasonable fluctuations in the prices of securities.

The 1934 Act expressly excludes debtor-creditor relationships represented by notes maturing in nine months of issuance. The interest with which we are concerned is mature at issue.

The Federal Bankruptcy Act, Title 11 U.S.C. §22, exempts State building and loan associations from federal bankruptcy adjudication. See *Security Building & Loan Assn.* v. *Spurlock,* 9 Cir., 1933, 65 F. 2d 768, 771, where the Court quotes extensively with approval from Rep. 98, 72d Congress, 1st sess. House Judiciary Committee; House Reports 2-659, 72d Cong. 1st sess., indicating Congressional determination to leave the administration of State created building and loan associations in the local [fol. 56] courts. We may assume that City Savings would be exempt from the provisions of the Bankruptcy Act. *Home Savings and Loan Assn.* v. *Plass,* 9 Cir., 1932, 57 F. 2d 117.

In *S.E.C.* v. *Joiner Corp.,* 320 U.S. 344, 352-3 (1943), the Court was considering whether assignments of oil leases were securities under the Act. In that connection the Court said:

> The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.

At another point (p. 351) the Court said:

> [T]he term "security" was defined to include * * * documents in which there is common trading for speculation or investment.

In *S.E.C.* v. *Howey Co.,* 328 U.S. 293 (1946) the Court said:

> The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.

An "investor" in a savings and loan association lends his money to be withdrawable at will and to earn interest. The relationship with the enterprise is much more that of debtor-creditor than investment. The profit is derived

from loans to other members of the savings and loan association. This is not investment in a common enterprise with profits to come solely from the efforts of others.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed in the aftermath of the great economic disaster of 1929. Congress was concerned with speculation in securities which had a fluctuating value and which were traded in securities exchanges or in over-the-counter markets.

The S.E.C. relies heavily on a recent amendment. Section 12(g), Title 15 U.S.C. §78 1* (g), provides for regis- [fol. 57] tration of certain equity securities. There is a specific exemption of "any security [with certain exceptions not pertinent here] issued by a savings and loan association" §12(g)(2)(C). The S.E.C. thus argues that the definition of "security", supra, must include interests which are referred to as securities in this exemption.

If these interests were already excluded by the definition, the Commission argues, then the exemption would be meaningless or would have to be interpreted as referring to some other undefined security of a savings and loan association.

In its Technical Statement on H.R. 6789, H.R. 6793, and S. 1642, submitted at the Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce; House of Representatives, 88th Congress, 1st Session (1963), p. 215, the S.E.C., while referring to all other interests which it recommended for exemption as being "securities", speaks of "share accounts" when referring to the savings and loan associations, suggesting that a distinctive view was held of these interests by the Commission itself.

The S.E.C. sees no significance in the omitting from the definition in the 1934 Act of the term "evidence of indebtedness" which does appear in the definition in the 1933 Act. These Acts were considered to have been sub-

* Lower case letter L.

stantially the same. The S.E.C. sees the omission as merely indicative of a different draftsman.

The Commission also notes that there was apparently no discussion of savings and loan interests at the time the 1934 Act was passed.

However, appellants invite our attention to the lengthy consideration of the term "evidence of indebtedness" in connection with the 1933 Act. (Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong. 1st sess., pp. 94-120 passim.)

Some of the Senators evidently saw a relationship between this term "evidence of indebtedness" and accounts in building and loan associations as well as between the term and various short term banking transactions. There was some fear that the 1933 Act would interfere with ordinary commercial banking transactions. The term was re-[fol. 58] tained but certain short-term debtor-creditor transactions were exempted. The same Congress which in 1933 had been considering the relationship between the term "evidence of indebtedness" and accounts in building and loan associations, excluded that term from the 1934 Act, retaining only such evidences of indebtedness as long-term notes, bonds and debentures. Yet the Investment Act of 1940, Title 15 U.S.C. §80a-2 (35), for example, retains the term in its definition of "security". Congress must have had some intention of excluding those interests which fell under the broad character of "evidence of indebtedness."

The definitions set out in the Act are all preceded by an introductory statement that they apply "unless the context otherwise requires."

Perhaps insurance policies may provide a useful analogy. In discussing mutual insurance companies over whom the S.E.C. does not claim jurisdiction, Chairman William L. Cary of the S.E.C. said:

> [W]e do say that mutual insurance companies are not included under this bill because the buyers in mutual insurance companies are fundamentally buying insur-

> ance. * * * and not stock. Furthermore, because there is no stock, there is no trading in the stock. (House Hearings, 1963, supra, p. 309.)

Basically that distinction applies to holders of "share accounts" in savings and loan associations. There is no stock or trading in stock.

A little later, Chairman Cary said:

> [S]ince the holders in mutual companies are policy holders, any wrongdoing would be the responsibility of the State superintendent of insurance.

With respect to City Savings, also, the local State authorities are ready and able to handle the orderly disposition of the institution's liquidation.

Insurance policies were exempted from the Securities Act of 1933 [Title 15 U.S.C: §77c(a)(8)] and under the 1964 amendments [Title 15 U.S.C. §78 l* (g)(2)(G)]. [fol. 59] Are they necessarily included in the definition of "securities"?

Professor Loss (*Securities Regulation,* 2d ed. 1961, p. 497) says that on its face the exemption of insurance policies in the 1933 Act seems to create a negative implication that insurance policies are securities which may be exempt from registration but are subject to the anti-fraud provisions. He observes that the Commission takes the position with respect to insurance policies that they are not intended to be "securities".

Chairman Cary advised, in the course of the Hearings before the Subcommittee in 1963, supra, p. 300, that while his Commission regulated offering of variable annuities as an offering of securities subject to the 1933 Act, he wanted to emphasize the fact that it was only the investment company operation that was regulated; that "we don't touch the insurance operations that they may have."

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* Lower case letter L.

Professor Loss also notes that the House Report states that the purpose of the exemption is to make clear what was implied in the Act, that insurance policies are not to be regarded as securities subject to the provisions of the Act. See H.R. Rept. 85, 73rd Cong., 1st sess. (1933) 15, cited in *S.E.C.* v. *Variable Annuity Co.*, 359 U.S. 65, 74, n. 4 (1959) in Justice Brennan's concurring opinion, where he states that under the Securities Act of 1933, it would appear that for ordinary insurance policies the exemption is just confirmatory of the policy's non-coverage under the definition of security.

H.R. Rept. 85 states that:

> The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.

It seems likely that the specific exemption of the interest here under consideration was also inserted for the same reason. This seems a more reasonable interpretation than that urged on us by the appellees and the Commission. [fol. 60] The appellees and the Commission cite a number of cases from which we are invited to draw analogies favorable to their view. However, these deal largely with the 1933 Act which included the broad term "evidence of indebtedness" which, as indicated, was excluded from the 1934 Act with which we are here concerned, or which are otherwise not directly helpful. Neither the parties nor this Court has found a case directly in point.

We have carefully considered all other arguments advanced and have studied all authorities cited. It is our opinion that these interests are not encompassed in the definition of a "security" under the 1934 Act; that the anti-fraud provisions of that Act are not here applicable; and that the District Court lacked jurisdiction of this cause.

The decision of the District Court is therefore reversed and the cause is remanded with instructions to dismiss the Complaint.

Reversed and Remanded With Instructions.

CUMMINGS, *Circuit Judge* (dissenting). My conclusion is that Chief Judge Campbell of the District Court correctly held that withdrawable capital shares[1] in Illinois savings and loan associations are "securities" within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934 (15 USC § 78c(a)(10)), so that the anti-fraud provisions of that statute are applicable to this case. Savings and loan passbooks typically describe the owners as holding a savings account representing "*share interests*" in the association. Many associations reserve the right to require 30 days' notice for withdrawals. Insurance, when available through the Federal Savings and Loan Insurance Corporation, gives $15,000 maximum coverage up to the [fol. 61] "full withdrawal or repurchasable value of the accounts of each of its * * * investors * * * holding withdrawable or repurchasable *shares*" (12 USC § 1728(a)). (Italics supplied.)

Section 3(a)(10) is quoted in the majority opinion and defines "security" as including, *inter alia,* any "stock * * * certificate of interest or participation in any profit-sharing agreement * * * transferable share, [or] investment contract". This definition is substantially the same as that contained in Section 2(1) of the Securities Act of 1933 (15 USC § 77b (1)), so that the legislative history and

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[1] *Arguendo,* the majority and this dissenting opinion consider these as withdrawable shares in accordance with the then applicable provisions of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1963, c. 32 § 773(h)). However, the complaint alleges that since 1959 the shares were sold on a restricted withdrawal basis. At trial, the District Court would have to determine whether defendants could sell shares restricted against withdrawal. That point has not been considered in this Court.

judicial construction of the definition in the Securities Act lend meaning to the definition in the complementary 1934 Act.

In enacting the Securities Act of 1933, Congress exempted "any *security* issued by a * * * savings and loan association" from the registration provisions while subjecting them to the fraud provisions of that statute (15 USC §§77c(a)(5) and 77q(a) and (c)). (Italics supplied.) While the savings and loan industry representatives were desirous of an exemption from the registration provisions of the 1933 Act, their spokesman, the late Morton Bodfish, supported the application of the anti-fraud provisions of the statute to the issuance of savings and loan shares, which he described *passim* as securities.[2] This specific exemption shows that when Congress wished to exclude savings and loan accounts, it knew how to do so. It has never chosen to exclude them from the anti-fraud requirements of the 1934 Act. The majority opinion relies on the securities exemption of ordinary insurance policies under the 1933 Act, but they differ from withdrawable capital accounts because they possess none of the attributes of securities. As Professor Loss observes, the exemption of insurance policies was supererogation due to an excess of caution. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 496-497. Therefore their exemption does not show they are subject to the anti-fraud requirements of the 1933 Act, particularly since the 1933 legislative history shows that they were "not to be regarded as securities" (*idem*).

[fol. 62] When Congress enacted the Securities Exchange Act of 1934, there was no discussion of savings and loan interests during the consideration of the definition of a

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[2] Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess., pp. 72-74. See also Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong. 1st Sess. pp. 50-54 (1933); Richards, *The Federal Securities Act*, Building and Loan Annals (1933), pp. 111, 115-118.

security in that Act.[3] However, in 1964, in amending the 1934 Act by providing for the registration of equity securities by certain issuers, Congress exempted "any *security* * * * issued by a savings and loan association" from the new registration provisions (15 USC § 78*l*(g)(2)(C). (Italics supplied) The then Chairman of the Securities and Exchange Commission, William L. Cary, explained the exemption as follows:

> "Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made to exempt that type of 'share'".[4]

No exemption would have been necessary unless shares in savings and loan associations were already within the definition of a security under Section 3(a)(10) of the Securities Exchange Act. This exemption was justified in the Senate Report on the ground that "There is normally no trading interest in the remaining *categories of securities* [including share accounts in savings and loan associations] exempted from the registration provisions." S. Rep. No. 379, 88 Cong., 1st Sess., p. 61 (1963). (Italics supplied) Thus the Senate Committee on Banking and Currency understood such share accounts to be "securities."

The definition of a "security" in the Securities Act of 1933 was involved in *Security and Exchange Commission* v. *W. J. Howey Co.*, 328 U.S. 293. The Court said that the term security "embodies a flexible rather than a static

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[3] There has been no showing that the deletion of "evidence of indebtedness" (found in the "security" definition in the 1933 Act) from the 1934 Act's definition of a security was intended to exempt savings and loan accounts. The author of the 1934 Act may have decided that inclusion of "evidence of indebtedness" would be poor draftsmanship, that term being inconsistent with the exclusion of "any note, draft, bill of exchange, or banker's acceptance" (15 USC § 78c(a)(10)).

[4] Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. p. 1213 (1963).

principle" in order to meet the "variable schemes devised [fol. 63] by those who seek the use of the money of others on the promise of profits" (at p. 299). Therefore, it held that a sale of a parcel of land in citrus groves, when coupled with a contract for management services, was an "investment contract" within the definition of a security under the 1933 Act. In language applicable here, the Court stated (at pp. 298, 299):

> "an investment contract for purposes of the Securities Act means a contract, transaction or scheme where a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."[5]

Here too the shareholders in this Illinois savings and loan association invested their money in a common enterprise and were led to expect profits from the efforts of others, *viz.*, the management. As in *Howey*, it is immaterial whether their shares were evidenced by formal certificates. Whether or not plaintiffs' shares are an "investment contract" under the *Howey* case, the Securities Exchange Act applies if they are "stock", a "transferable share" or a "certificate of interest or participation in a profit-sharing agreement." The subsequent clause in Section 3(a)(10) referring to "in general, any investment commonly known as a 'security'" is not a limitation upon the preceding categories. *Llanos* v. *United States*, 206 F.2d 852, 854 (9th Cir. 1953) certiorari denied, 346 U.S. 923. It must be remembered that these various categories in Section 3(a)(10) are not mutually exclusive and are meant to be "catchalls". 1 Loss, *Securities Regulation*, (2d ed 1961) pp. 483, 488-

[5] The broad *Howey* formula has been codified into a rule under the Illinois "blue sky" statute. 1 Loss, *Securities Regulation* (2d ed 1961), pp. 487-488, note 79. Ill. Rev. Stat., 1965, C. 121½, § 137.1—1.

489. The breadth of the definition of security in the two Acts is shown by Professor Loss' illustrations of coverage in cases involving animals, fishing boats, automobile trailers, vending machines and parking meters, cemetery lots, tung trees, vineyards, fig orchards, farm lands, and patent [fol. 64] rights. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 490-491 and 1962 Supplement, p. 30. All sorts of schemes, "many of them of the Alice in Wonderland variety", are regulated through "the *Joiner-Howey* process of looking through form to substance" and through the broad definition of "security" founds in the two Acts. *Idem*, pp. 488-489. Under the definition of a security under the 1933 and 1934 Acts, a writing is not essential. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 458, 488-489. Moreover, these passbooks would qualify as writings and indeed as certificates "of interest or participation in any profit-sharing agreement" (15 USC § 78c(a)(10)).

As observed in a similar context, it is unnecessary to pigeonhole these withdrawable capital shares into one category of security or the other. Cf. *Securities and Exchange Commission* v. *Variable Annuity Co.*, 359 U.S. 65, 80 (concurring opinion). In addition to the *Variable Annuity* and *Howey* cases, *Securities and Exchange Commission* v. *Joiner Corporation*, 320 U.S. 344, indicates that these companion statutes must be liberally construed in view of their remedial purpose. There the "investment contract" part of the security definition in the 1933 Act was deemed applicable to non-standard offerings of variable character (at p. 351). Our Court has also favored a broad construction in *Securities and Exchange Commission* v. *Crude Oil Corp.*, 93 F.2d 844, 846 (7th Cir. 1937); and *Securities and Exchange Commission* v. *Universal Service Corporation*, 106 F.2d 232, 237 (7th Cir. 1939), certiorari denied, 308 U.S. 824.

Although the foregoing cases involved the Securities Act of 1933, the definition of a security in the Securities Exchange Act was involved in *Securities and Exchange Commission* v. *Los Angeles Trust Deed & Mortgage Exchange*,

186 F. Supp. 830, 886-888 (S.D. Cal. 1960), affirmed in pertinent part, 285 F.2d 162 (9th Cir. 1960), certiorari denied, 366 U.S. 919. In affirming the District Court's holding that defendant's sales of second trust deeds constituted sales of "securities" within the 1933 and 1934 statutes, the Ninth Circuit noted that "Howey adds the test of *common enterprise* to the Joiner test of *results dependent on the efforts of one other than the purchaser*" (285 F.2d at p. 168; court's [fol. 65] italics). There the defendant selected a trust deed for the investor and serviced it by making the collections from the grantor-debtor and by doing the bookkeeping. Basically the system was very much like a savings and loan association, for funds supplied by investors were used to finance secured loans on real property. In *Los Angeles Trust Deed,* the investors' money was used to buy a particular deed, whereas savings and loan associations make their loans from commingled savings. This difference satisfies the "common enterprise" *Howey* test even more than the trust deed system in *Los Angeles Trust Deed.* Under that case, the instant plaintiffs' shares clearly represent an "investment contract" within the security definition in the 1934 Act.

In *Securities & Exchange Commission* v. *American International Savings and Loan Ass'n.,* 199 F.Supp. 341, 346 (D.Md. 1961), the association's articles provided for preferred stock to be known as preferred share or savings share accounts. Deposit books were issued to depositors who were entitled to receive cumulative dividends of at least 3½% before any dividends were paid to common stockholders. Since the court held that defendants violated the 1933 Act, it necessarily concluded that this preferred stock, which resembled withdrawable capital shares in the City Savings Association, was a security within the purview of the 1933 Act.[6] Applying *American International* here would

[6] In *United States* v. *Hopps,* 215 F.Supp. 734, 754 (D.Md. 1962), affirmed 331 F.2d 332 (4th Cir. 1964), certiorari denied, 379 U.S. 820, the same judge described interests in savings and loan associations as "securities".

mean that these shares qualify as securities under the like definition in the 1934 Act.

A recent Illinois decision involving a savings and loan association also shows that these withdrawable shares are "securities". Thus in *Marshall Savings and Loan Association* v. *Henson,* Ill. App.2d , N.E.2d (No. 51485, 1966), the Appellate Court of Illinois observed "that the Illinois Savings and Loan Act gives the depositors the status of *shareholders* by conferring one vote for each $100 on deposit" (italics supplied). There it was held that the Federal Savings and Loan Insurance Corporation, as assignee of Marshall's withdrawable share accounts, [fol. 66] had obtained the right to vote the "stock" or "shares" even though Marshall's members had not endorsed their certificates or passbooks to the Federal Savings and Loan Insurance Corporation. Similarly, *Wisconsin Bankers Association* v. *Robertson,* 294 F.2d 714 (D.C. Cir. 1961), certiorari denied, 368 U.S. 938, concluded that the holder of a savings account in a savings and loan association was a shareholder and not a creditor of the association, and that such associations were not banks. The concurring opinion of Judge Burger noted that the owner of a savings and loan association account is an investor and is entitled to vote for management. See also *Aetna Casualty & Surety Company* v. *Porter,* 296 F.2d 389 (D.C. Cir. 1961), reversed on other grounds, 370 U.S. 159. As further evidence of the distinction between savings and loan associations and banks, we have been advised that as of December 31, 1965, the mortgage loans of savings and loan associations were 85.14% of their total assets, whereas the comparable percentage for commercial banks was only 13.11%. Banks are in a much more liquid position than those associations, demonstrating that investors in such associations need the disclosures required under the 1934 Act.

The majority opinion and the defendants reason that these withdrawable capital accounts form a "debtor-creditor relationship" and are not investments. This reasoning is contrary to Section 4-13(f) of the Illinois Savings and

Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f), which provides:

> "The holder of withdrawable capital for which an application for withdrawal has been made, does not become a creditor by reason of such application."

Both the *Wisconsin Bankers* and *Aetna Casualty* cases also hold that a creditor-debtor relationship is not present here. If these shareholders were creditors, they would be entitled to interest. Actually they are entitled to receive only dividends payable out of the association's profits, if any.

To avoid the security definition, appellants emphasize the withdrawability and non-preemptive rights attached to these savings and loan shares, but the same is true [fol. 67] of mutual fund shares. They are of course "securities" subject to the anti-fraud provisions of the 1933 and 1934 Acts. Also in truth these savings and loan shares are less "withdrawable" than stocks which can be sold immediately merely by phoning a broker. As to savings and loan shares, the investor may have to wait 30 days or more for withdrawals, and the association may limit the amount of withdrawals (Ill. Rev. Stats. (1965) c. 32 § 773(a) and (b)). If as here, the association has suffered reverses, withdrawability is an empty right. Also, these shareholders' right of redemption and their right to vote for directors, to participate in dividends, and to obtain a certificate of ownership are all common characteristics of securities. It is immaterial that they had no right to inspect City Savings' books and records. Neither do bondholders or holders of such interests as involved in *Howey*, and yet the 1934 Act applies to those categories.

Defendants and the majority opinion assert that these savings and loan interests are not securities because the Illinois Savings and Loan Act provides that they are not subject to Article 8 of the Uniform Commercial Code (Ill. Rev. Stat., 1965, c. 32 § 768(c)). However, if the Illinois Legislature did not consider these accounts to be securities, there would have been no need to exclude them

from the Uniform Commercial Code. The comment on Article 8 of the Uniform Commercial Code recognizes that the definition of security contained in Article 8 is less broad than the Securities Act of 1933, the Securities Exchange Act of 1934, and the Illinois Securities Law of 1953. (See Uniform Commercial Code, Illinois comment, Smith-Hurd Ill. Stats. Ann., c. 26 § 8-102.) It is significant that the Illinois Securities Act of 1953 recognizes withdrawable capital share accounts as securities. Thus that Act affords an exemption to "the following securities: * * * Securities issued by * * * any savings and loan association * * * " (Ill. Rev. Stats., 1965, c. 121½, § 137.3D).

The majority opinion and the defendants also rely on the short-term commercial paper exclusion in the definition of "security" in Section 3(a)(10) of the Securities Exchange Act for "currency, or any note, draft, bill of [fol. 68] exchange, or banker's acceptance" having a maturity not exceeding nine months at issuance. Plaintiffs' interests in City Savings are neither currency nor short-term commercial paper of non-investment character and therefore do not fall within this exclusion. Finally, in this connection, Section 4-13(f) of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f)), providing that a holder of withdrawable capital does not become a creditor even upon filing an application for withdrawal, rebuts any argument that plaintiffs' interests were short-term debts within the commercial paper exclusion.

Defendants and the majority opinion point to the savings and loan association exemption in the Federal Bankruptcy Act (11 USC § 22) in an effort to show that Congress intended to exempt such associations from all federal regulation. But railroads, for example, are also exempted from the Bankruptcy Act, and of course their securities are subject to the Securities Act and the Securities Exchange Act. The exemption of an association from one federal Act certainly does not show that it is to be exempted from the scope of other federal Acts.

The opponents of federal regulation emphasize the nonmarketability of these shares, but the scope of the 1934 Act is of course not limited to securities traded on markets. *Schine* v. *Schine*, 250 F.Supp. 822, 823 (S.D.N.Y. 1966) and cases cited. These shares were transferable,[1] and at the oral argument it was undenied that such shares have been traded over-the-counter. The preamble of the Securities Exchange Act covers the regulation of over-the-counter markets (H.R. 9323, Public No. 291, 73d Cong., 1st Sess. (1934)), and Section 10(b) of the Act reaches manipulative or deceptive devices or contrivances employed in connection with the purchase or sale of any security not registered on a national exchange (15 USC § 78j(b)). Because shares in savings and loan associations are sold on over-the-counter markets, the SEC has required the registration of brokers who deal solely in such shares. In any case, the oil leases, orange groves and variable annuity policies involved in the Supreme Court's *Joiner, Howey* and *Vari-*
[fol. 69] *able Annuity* cases were not traded on exchanges or over the counter, and yet all were held to be securities even though they had none of the ordinary characteristics of securities described in the present majority opinion. Also, none of those cases relied on "evidence of indebtedness" as found in the 1933 Act's security definition. Hence the absence of that term from the otherwise similar definition in the 1934 Act does not show that the other terms in the 1934 definition must be given a narrower construction. In that trio of leading cases, it was much more difficult to justify applicability of the federal statute than here, for there was seemingly a strong Congressional policy against federal regulation, less need for investor protection and less statutory support. Here, as seen, the savings and loan industry welcomed the federal anti-fraud umbrella, the investors need federal protection, and the 1934 statutory definitions of a security are clearly broad enough to cover these shares.

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[1] Section 4-8(b) of the Illinois Savings and Loan Act (Ill. Rev. Stat. (1965), c. 32 § 768(b)).

Policy considerations also require affirmance of the decision below. The typical savings and loan account-holder is a small investor, as unwary and in need of protection as a typical, unsophisticated holder of corporate stock. Protection is especially warranted here, for compliance with rules and regulations under Section 10(b) of the 1934 Act (15 USC § 78j(b)) would not involve any excessive burden on these associations, nor is there any undue intrusion on State regulation. In fact, the briefs of the Illinois Attorney General point to no comparable Illinois statutory protection and do not show as a matter of federal-state relations why the 1934 Act should not be applied.

Defendants assert that the federal anti-fraud provisions were meant to inhibit artificial price levels of shares and that these shares do not fluctuate in price. However, the shares here do fluctuate in value. If the association is successful, the investors' holdings are worth more than the price paid. If, as here, the association is unsuccessful, the shares become worth very little. It is the fluctuation in value of their shares that is important to these shareholders. Even though not always a panacea, the use of the federal anti-fraud provisions would help to guard against [fol. 70] circumstances that would plummet the share value downwards.

The investors in City Savings were less able to protect themselves than the purchasers of orange groves in *Howey*. These plaintiffs had to rely completely on City Savings' management to choose suitable properties on which to make mortgage loans. Cf. *Penfield Co. of California* v. *Security and Exchange Commission*, 143 F.2d 746, 751 (9th Cir. 1944) certiorari denied, 323 U.S. 768. The members of City Savings were widely scattered. Many of them probably invested in City Savings on the ground that their money would be safer than in stocks. They doubtless expected insurance through the Federal Savings and Loan Insurance Corporation or other sources. Through SEC regulation helpful information would be available to these investors. Through disclosure. they would have learned

that City Savings was financially embarrassed and on a limited withdrawal basis, that it had been unable to obtain federal insurance for its shareholders, that its one-year Morocco insurance had not been renewed, and that C. Oran Mensik (whose management had been criticized by the Federal Savings and Loan Insurance Corporation) was connected with City Savings. Instead, City Savings was enabled to speak of its financial strength and to advance reasons why investors should purchase shares therein. Because savings and loan associations are constantly seeking investors through advertising (see, *e.g.*, New Year's Savings & Loan Association Supplement, *Chicago Tribune*, December 27, 1966), the SEC's present tender of its expert services should be especially beneficial to would-be savings and loan investors as a shield against unscrupulous or unqualified promoters. Nothing in the 1934 Act or the cases under the two Acts stands in the way of such anti-fraud protection. The District Court was clearly correct in affording it.

....., Clerk of the United States
Court of Appeals for the Seventh Circuit.

[fol. 71]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Before Hon. Win G. Knoch, Circuit Judge, Hon. Roger J. Kiley, Circuit Judge, Hon. Walter J. Cummings, Jr., Circuit Judge.

Nos. 15631, 15633, 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

JOSEPH E. KNIGHT, Director of Department of Financial Institutions, et al., Defendants-Appellants.

Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.

JUDGMENT—January 20, 1967

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said District Court in this cause appealed from be, and the same is hereby, Reversed, with costs, and that this cause be, and it is hereby, Remanded to the said District Court with instructions to dismiss the Complaint, in accordance with the opinion of this Court filed this day.

[fol. 72] Clerk's Certificate to foregoing papers (omitted in printing).

[fol. 73]

SUPREME COURT OF THE UNITED STATES

No. 1301, October Term, 1966

ALEXANDER TCHEREPNIN, et al., Petitioners,

v.

JOSEPH E. KNIGHT, et al.

ORDER ALLOWING CERTIORARI—June 5, 1967

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.